



A STUDY ON EXIT STRATEGY OF STARTUPS FIRMS IN INDIA – AN EMPIRICAL ANALYSIS

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ABSTRACT

In the modern age, the Indian start-up ecosystem has taken off and come into its own driven by factors such as massive funding, consolidation activities, evolving technology and a growing domestic market. The numbers are telling from 3,100 start-ups in 2014 to a projection of more than 50,000 by 2022, this is certainly not a passing trend. We investigate the corpus of literature on firm exit by means of a systematic literature review (SLR). Special attention is given to the various exit routes, including voluntary liquidation, mergers and acquisitions (M&A), initial public offerings (IPO), and of course bankruptcy. The current study is exploratory and descriptive in nature. The data is collected and analyzed to describe the variables and determinates of exit strategies of Startups firms in India.

Key words: Start-ups, Exit strategies.

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1. INTRODUCTION

For any country or economy to grow, there is a necessity to develop robust financial ecosystem which should be capable of creating new companies. Today, the world has great demand for innovation and it has become imperative to create an ecosystem to promote and transform the entrepreneurship ideas to revenue generating companies. For many people, Venture Capital is the money for start-ups and great ideas. Generally, private investor or 'angels' are known as a principal source of funds for start-ups and great ideas. Many times, the venture capital companies also define venture capital as money for the expansion of existing businesses too (Gopinath, 2019a). It is also defined as money invested in small and medium enterprises which

are giving minority shareholding in the business and irrevocable right to acquire it. Khan, 1998 said that over a period of time the concept of venture capital has been shifted from technology-oriented manufacturing organizations to being very close to 'private equity classes for unlisted new companies (Gopinath, 2019b). The young and new companies face challenges of equity gap (Wetzel, 1983) and competency gap (Barth 1999). The complexities in the new business increase with the development of the new idea into a growing business (Klofsten, 1992; Greiner, 1972). The venture capital firms provide both equity and competence to these young firms with great potential of capital growth.

“What is your exit strategy?” This is one of the most common questions that start-ups or early stage companies are asked, but many entrepreneurs don't give their exit strategy much thought at the very beginning. An “exit strategy” does not refer so much to your departure from the company (although it might), but rather how an investor will make a return on his/her/its investment. Although it may seem counterintuitive, thinking about your exit strategy up front can help you determine how best to structure and operate your company, and many investors will want to know your planned exit strategy before they invest. Keep in mind that these various strategies are also not mutually exclusive, and your company may experience one or more of these through its lifetime.

Cash Cow The simplest answer for what is your exit strategy would be “None!” Some founders want to stay intimately involved with the operation of the business and may not be looking for or relying on outside investors, often citing a desire to grow “organically.” That “organic” growth tends to be slower than the growth of a company that receives large capital infusions from investors, but keeping ownership and control is often more important to those founders (Gopinath, 2019c). **M&A** --- aka Mergers & Acquisitions For a startup, this means the sale of all or a part of your company (either the assets or the equity) to another person or entity. To address a common misconception, an M&A transaction for the equity of a company is not the same as issuing equity as part of a financing round. In a financing round, an investor typically acquires equity directly from the company, and all your existing equity holders continue to be equity holders. Conversely, M&A is a sale of already issued and outstanding equity from a current equity holder to a third party (Gopinath & Meenakshi, 2019). That current equity holder sells its shares and receives cash (or other compensation) in exchange for those shares. M&A may look very different for different companies, whether a buyer is strategic or private equity or whether the sale is for all or less than all of a company. To read more about this exit strategy, read my detailed blog post. **IPO** --- Initial Public Offering The IPO is experiencing a resurgence in popularity in recent years, with well-known companies like Uber, Spotify, Blue Apron, and Beyond Meat going public in the last few years to great fanfare. Other big names like Smile Direct Club, Peloton, and WeWork are hot on their heels and set to go public in late 2019. “Going public” is shorthand for becoming listed on a stock exchange (typically either the New York Stock Exchange or the Nasdaq) and sales of the company's stock are then bought and sold on the open market (Gopinath & Kalpana, 2019) Public companies are subject to extensive reporting requirements by the Securities and Exchange Commission, so the administration and legal requirements for a company to go public (and remain public) are expensive and time consuming. However, being a public company is often the best decision to maximize return for investors when a company reaches a high enough valuation and the “exit” with an IPO can be extremely lucrative. Although going public is not a short-term plan, it is still the ultimate goal for many start-ups. There are also less glamorous or profitable ways of “exiting” a business as a founder if the situation requires: selling/redeeming equity (while the other owners continue to operate the business) or even dissolution of the company as a whole. These may or may not be the exit strategy you initially envisioned when forming your company, but they can be useful options for a founder (Gopinath, 2016). Considering your exit strategy from the beginning is important not only for you as you grow your company, but for

your investors and their bottom line. Each option has its own legal advantages and disadvantages, and your investors may have their own ideas.

2. LITERATURE REVIEW

There is recognition in the literature that venture capital investments are risk intensive, thus, the investments' liquidation opportunities become one of the key issue in the venture capital investment process (Snieska & Venckuviene, 2011). Risk is inherently associated with the essence of PE funds operations that involve the engagement of investors' own resources in other enterprises. During such cooperation, PE funds are exposed to two basic risk types: market risk and agency risk (Fiet, 1995). Market risk results from the unpredictability of such factors as: range and dynamics of the demand for the product, competitors' activities, and potential in market development. Agency risk is associated with the so-called agency conflict, which appears when the owner's and the agent's aims are at odds (Gopinath & Chitra, 2020a). The basic sources generating agency risk include differences of opinions of capital providers from VC funds and the enterprise's founders as regards the managing of the enterprise, as well as insufficient competences of and searching for side profits by entrepreneurs who can still make decisions in the enterprise. For example, by making overly optimistic estimates of the firm's revenues, the managers may try to inflate the expected value of the firm, which in turn increases their rewards from the IPO (Bruton et al. 2010). Cummming and Johan (2014) note that there are two fundamental exit routes for successful entrepreneurial firms backed by VCs; initial public offerings (IPOs) and acquisitions (sometimes referred to as a trade sales). Gerasymenko and Arthurs (2014) emphasize that IPO is, in general, a more standardized procedure with requirements that are relatively clear from the outset than is a trade sale process that may vary on a case-by-case basis. Determining whether to go public or not involves a number of factors. Moore et al. (2012) emphasized the importance of the IPO because it represents a significant shift in the strategic choices open to the firm. IPOs give firms expanded access to capital, allowing them to continue growth, expand and improve company image and increase shareholder liquidity. More importantly, IPOs are the exit channel for the most successful ventures (Bertoni & Groh, 2014). Carrying out an IPO benefits both the entrepreneur and the venture capitalist. PE funds typically maintain a certain portion of their companies' shares at the time of the IPO and they benefit from any post-IPO increases in a portfolio company's value. Unlike a sale to a third party (particularly to a strategic buyer), the management team, enhanced by incentive compensation devices such as stock options, are more likely to support an exit through an IPO. Meluzin & Zinecker (2014) suggest that the companies often choose this form of financing to raise the necessary capital and to gain a non-financial advantage from IPO implementation, such as the greater attention that the media pay to publicly traded companies. Furthermore, entrepreneurs have a nonpecuniary preference for being the CEO of a publicly traded firm (Cumming & Johan, 2014). With respect to exiting via the IPO market, there is also an important aspect of the venture capitalists reputation. VCs are identifiable players in the IPO market who are typically engaged in IPO markets more than once during their economic lifetime. VC managers' abilities to raise additional funds depend on their reputations with investors, by means of realizing a successful IPO with high returns as soon as possible. These venture capitalists build a reputation for selling high-quality ventures at their true value and not reporting falsely on the quality of their ventures (Neus & Walz, 2005). Reputation is generally considered essential in the PE industry because IPOs are sold to a large number of diverse shareholders, many of whom do not have the time, inclination or expertise to carry out due diligence on the quality of the firm being sold. As argued by Cumming and Johan (2008), IPOs are typically the most difficult exit outcome to achieve, as information asymmetries are the most difficult to overcome. Cumming, Fleming and Schwienbacher (2006) find that an active stock market and the quality of the legal environment facilitate exit via IPO.

Black and Gilson (1998) as well Kaplan and Schoar (2005) stress that welldeveloped stock markets are crucial for exit strategies via IPOs. Giot and Schwienbacher (2007) also find that local stock market conditions have a positive impact on IPOs. As noted by Jeng and Wells (2000), divesting is more difficult, and less likely to be successful in countries with illiquid capital markets. Hursti and Maula (2007) examine the factors affecting foreign IPOs by European companies. The authors note that foreign investors bring additional experience to the local PE market. They also argue that firms backed by an international syndicate of VC investors are more likely to go public on a foreign exchange. Lewis (2011), using a sample of UK IPOs, finds evidence that PE-backed IPOs at the time of flotation are larger in terms of market capitalization, total assets, and sales are more profitable, maintain higher levels of debt, and are less underpriced than other IPOs. Recent research revealed that the overall earnings management in CEE region is rather favorable for the CEE investors as earnings manipulation is on a rather low level, based on the accruals analysis and comparison of net income to operating cash flow (Bistrova & Lace, 2012). There is also evidence that the financial sector influences economic growth of the region (Lakstutiene, Krusinskas & Platenkoviene, 2011). Rupeika-Apoga (2014) reports that SMEs' access to alternative financing (business angels, venture capital funds, different government support programs seed funding and crow-finding) in the Baltic States is improving (Gopinath & Chitra, 2020b)

3. METHOD

This article starts with the pre-existing literature review in order to examine the potential factors that might affect PE exit outcomes in terms IPOs. Research methods cover the comparative analysis of scientific literature documents and reports as well as statistic data. The statistical data used in the article has been based on publications and reports of the Private Equity and Venture Capital Association.

4. RESULTS

In the last decade, Indians have taken up business ventures to the next level, whether it's IT or FMCG. The role of private market investors has been significant in the success of these ventures. The year 2019 was a revolutionary period for Indian start-ups as it has recorded the highest number of unicorns. Many investors liquidated their stake in the companies, out of which many were venture capital firms.

PE or Private equity exit refers to the selling of a stake by the investor in the investee company. This is done by way of, secondary sale of shares, IPO or M&A.

There was an exceptional surge in Private equity exit deals in 2019 compared to 2017 or 2018. Total 272 deals in 2019 amounted to a whopping amount of \$38.76 billion which is 270% higher than the number recorded in 2019. The deals in 2019 were largely impacted by the covid pandemic and therefore, it amounted to a modest \$6.9 billion only. Out of the deals in 2019, complete exit deals were more in comparison to partial exists. The year was lucrative for investors both in terms of investments and exit, which is a healthy sign for the private market investors.

4.1. Top Exits by Size

The largest deal of the year 2019 was of GlobalLogic, a Noida-US-based private company, by Tokyo's Hitachi for \$9 billion. The PE companies that sold their stake were Partner's Group and CPPP. When India's largest fintech company, PayTM got listed in November 2019 for \$1.3 billion as an Offer for Sale, investors made a partial exit. Bangalore-based Venture capital firm, BigBasket was valued at \$1.8 billion post-acquisition when TATA digital Ltd. bought it from

Alibaba, Abraaj Group, and Ascent Capital. The initial value pegged was \$1.2 billion. Hence, investors booked profit on their investments in some of the most successful ventures in India.

4.2. PE Exits by Profitability

In 2019, many investors made exits from their investments and took back home a handsome amount of money. Info Edge sold its stake in Zomato through IPO, which earned the former 65.52 times of the initial investment. The second most profitable deal was a complete exit by clear stone on its 15 years old investment in BillDesk. An Indian cosmetic start-up, Sugar cosmetics, fetched India Quotient, 49 times the initial investment in just 7.76 years by the partial exit.

4.3. PE Exits by Industry

The IT industry has witnessed the highest number of PE exit deals in 2019, which is 23.5% of the total PE exit deals in 2019. The amount liquidated in this sector was \$23,508 million which was followed by BFSI for the amount of \$5,097 million. It is no gain saying that the IT industry has seen a spurt in growth and innovation, and therefore, people are willing to pay more than the market value. The lowest PE exit deals were in the energy sector, which was at \$0.9 billion, as this is a more mature market.

4.4. PE Exits by Value and Volume

Even after declining from 2018 to 2019, the IT sector held a major share in the value of deals in PE exits. In 2019, the PE exit deals were largest in the BFSI sector because of the pandemic that exhorted people to take insurance and investments along with loans as the interest rates lowered significantly. But in 2019, the largest share of value in these deals was recorded in the IT sector. This is due to the scope of further innovation and expansion in the IT sector. The potential of AI and machine learning is yet to be fully exploited. BFSI, being the second most valuable industry for PE exit, shows that this sector is promisingly growing, making people more informed about alternatives of investments and the importance of insurance after the pandemic, specifically. Therefore, PE exits in this sector grew by a modest margin in 2019.

4.5. PE Exits by Type

In 2019, there were a total of 89 deals through strategic sale routes amounting to \$14.55 billion. It constituted 38% of the total value of PE exits followed by Public Market Sales and Secondary Sales that amounted to \$12.13 billion and \$11.03 billion. Here, we see that Buyback is the least preferred means for exit deals.

5. CONCLUSION

The above highlights the significance of the year 2019 for the business world, especially from the viewpoint of an investor. PE exit deals were at an all-time high, and it realized the maximum value from the sale of venture capital firms. As the Indian market ecosystem has embraced start-ups wholeheartedly, investors are looking to realize their profit by selling their stake in the booming economy.

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